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E-BRIEF

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TRADE AND INTERNATIONAL POLICY

The Impact of Diplomatic Representation Abroad on Canada's Exports

by

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- With the federal government having prioritized "economic diplomacy" for overseas posts, along with a major budget consolidation, it is essential that Ottawa get the process right.
- This E-Brief assesses the impact of Canada's diplomatic representation abroad on exports. It concludes that economic diplomacy boosts exports – and quite significantly – and sheds light on the questions of where, why and how.
- The main policy findings are that maintaining high-level diplomatic relations, through an embassy, has of itself a larger positive impact on exports than the deepening of relations via additional posts, and that the existence of a trade agreement with a destination market has a significant positive influence on Canadian exports to that market. The results suggest that there is a definite importance in the "G2G" (government-to-government) relationship as distinct from the role of government in providing "B2B" (business-to-business) trade facilitation.

Through the Global Markets Action Plan (GMAP), the Government of Canada seeks to ensure that "all the diplomatic assets of the Government of Canada are harnessed to support the pursuit of commercial success by Canadian companies and investors in key foreign markets."[1] However, constraints have been placed on economic diplomacy funding by a major budget consolidation

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1 Foreign Affairs, Trade and Development Canada, (13 January 2014).

exercise, which has led to closures of embassies, consulates, and trade offices around the world. Canada has also reached an agreement with the UK to share space in embassies for budgetary reasons. The new GMAP will lead to strategic decisions concerning the allocation of Canada's limited trade promotion resources by amount, program and geographic direction.[2]

The economic literature identifies significant differences in the effectiveness of export promotion across the various methods employed, as well as across contexts, products, and destinations. There has been very limited relevant work on this issue from a Canadian perspective. Head and Ries (2010) found that Team Canada missions did not have a significant impact on future Canadian exports. Rose (2007) provided several estimates for the impact on Canada's exports of embassies and consulates, which indicated that these posts provided a positive impact on Canadian exports. In a study on Canadian export promotion services, Biesebroeck, Chen, and Yu (2010) found that exporters that access Trade Commissioner services export, on average, 17.9 percent more than comparable exporters that do not get such assistance.

With economic diplomacy attracting renewed policy attention, I revisit the issue of the impact of Canada's diplomatic representation abroad on exports. I confirm that economic diplomacy does appear to boost exports – and quite significantly – and add to the existing literature by shedding light on the questions of where, why and how. I find that the impact is greater for the first, main post (usually an embassy) than for additional consulates; that the impact is stronger on undifferentiated commodities, such as agricultural commodities, than for manufactured goods; and that the impact is greater in countries which are characterized by lesser degrees of economic freedom. The results point to separate, significant effects of diplomatic relations and of trade agreements on trade that are over and above the export gains from having additional Trade Commissioner "boots on the ground" in Canada's targeted export destinations.

The Effectiveness of Export Promotion: What Works and How Well?

Governments worldwide expend considerable resources to promote exports. For example, US spending on export promotion has been estimated at US$1.3 billion (about 0.08 percent of US goods and services exports' value) spread over nine agencies.[3] By comparison, Canada's federal budgetary allocation for international commercial development (including investment and exports) amounted to C$309 million in fiscal 2013/14 (about 0.06 percent of Canadian goods and services exports value), evenly split between Foreign Affairs, Trade and Development Canada and Agriculture and Agri-Food Canada.[4]

The economic case for this type of government intervention rests on the concept of "market failure." Potential exporters face costs in establishing themselves in foreign markets. They also face greater uncertainty in foreign

2 The update of the federal government's first Global Commerce Strategy (GCS) was announced in the 2012 Budget. On 29 May 2012, Canada's Minister of International Trade announced the establishment of a panel to advise on how to frame the next version of the GCS to maximize Canadian businesses' economic opportunities.

3 GAO (2009). The US expenditure level relative to the value of goods and services exports is double the median of export promotion agencies surveyed by Lederman, Olarreaga, and Payton (2010), but within the OECD range of 0.03 to 0.13 percent as reported in that study.

4 A similar study to the GAO Report conducted in a 1996 Report by the Auditor General. This study found the cost of federal activities in support of international business development to be greater than $375 million a year, not including overhead costs in Canada, or about 0.13 percent of Canada's exports at the time. See Office of the Auditor General of Canada, *1996 November Report of the Auditor General of Canada* (Ottawa: OAG, 1996).

markets, as they have less knowledge than established local firms about these markets. While this creates incentives for business to provide solutions, market responses are likely to be inadequate. The main reason is that knowledge about export markets tends to "spill over" from one firm to another. A pioneering firm learns the ropes of exporting to a particular market at some expense to itself – either the costs associated with trial and error "learning by doing" or the cost of purchasing legal advice and market intelligence. At least some of the benefits of this knowledge leaks out to imitators. Economic theory predicts that the private sector will under-invest in areas where the investor does not capture the full returns, and there is some evidence to suggest that this is the case with firms entering export markets. Since firms that enter foreign markets tend to take productivity-enhancing actions, such as investing in new production processes, increasing resources allocated to innovation and increasing personnel training, underinvestment in export-market entry weakens this important dynamic.

Policies to promote exports are multi-faceted. Programs often include building export capability at the firm level (for example, by providing exporter training), explicit export strategies targeting "priority markets,"[5] and high-profile trade missions (for example, Team Canada).[6] Export credit or financing agencies address specific gaps in export financing. Finally, governments (including sometimes provincial governments) engage in commercial diplomacy through embassies, consulates, and trade promotion offices in partner countries.

An accumulating body of evidence[7] suggests that trade promotion can be effective, but that the impact varies systematically according to various factors:

- the type of service provided;
- the export destination targeted (including the degree of economic freedom in such destinations);
- the size of firms to which services are provided (smaller, less experienced firms versus established exporters);
- the location of delivery (in the exporting country versus in the field);
- the types of goods targeted (differentiated versus undifferentiated goods, as well as goods versus services);
- the nature of the markets in which the goods are traded (e.g., government procurement versus commoditized markets) or services provided (e.g., establishing commercial presence in regulated sectors, such as financial services and telecommunications); and
- in the case of posts abroad, the level of representation (e.g., embassies versus consulates or trade offices).

The Empirical Approach

This study examines the effectiveness of Canadian posts abroad in expanding Canada's exports with what is called the "gravity model" of international trade. This widely used model explains the level of exports to a country based on the size of the destination market, its distance from the exporting country, and various factors that impact on the costs of doing business in that market These can include whether the exporting and importing countries

5 Examples include the US "National Export Strategy" and Canada's recently announced Global Markets Action Plan. Notably, the most successful export promoters – the major East Asian export-oriented economies – tend not to openly label their policies as such.

6 Since 1998, Canada has mounted 44 Team Canada missions.

7 See the companion piece technical paper for a detailed discussion of the literature in this area.

share a common language, the depth of historical political ties, whether they have a free trade agreement in force, and so forth.[8]

I examine the impact of different levels of diplomatic representation, with separate indicators for an embassy, a consulate, a trade office, and whether the country is served by a Canadian post in a neighbouring country. This allows consideration of whether the level of representation matters, and in particular whether it is pure "economic diplomacy" (in the sense of political relations) or the opening of additional posts once economic diplomacy is engaged that makes the difference. As an added wrinkle, I make use of the fact that Canada and Australia provide consular services for each other in particular countries to see whether export performance in these markets is affected.

I use several different export variables: total exports, total exports excluding mined products, and manufactured goods. This controls for the fact that trade in mined products tends to be highly regionalized because of high weight-to-value ratios. It also sheds light on the effectiveness of export promotion for more differentiated products.

The study also controls for the degree of economic freedom in destination markets, to test the hypothesis that economic diplomacy may play a larger role in countries where governments intervene more heavily in economic decision-making.

Due to a very high degree of similarity between Canada and Australia in terms of economic structure, socioeconomic conditions, governance frameworks, and geopolitical clout, I include Australia as a control. Whereas the average effect of a post for a diverse group of countries as derived by Rose (2007) may or may not be representative of the effect for Canada, one would expect similar results for Australia and Canada. However, there is one characteristic in which Canada and Australia differ sharply: Australia is "remote" from global economic activity, while Canada is close to its centre of gravity. Including Australia in the study controls for whether this factor impacts materially on the results.

The study draws on Canada's annual bilateral exports over the period 2002-2012 to a set of 150 countries for which all data were available, excluding several countries affected by trade sanctions or turmoil (Belarus, Iraq, Myanmar and Syria).

Results

The estimation results confirm that "gravity" works for Canada – that is, Canada's exports fit reasonably well with the pattern predicted by the vast gravity modelling literature, including the strong positive effect of preferential trade agreements on exports – and shed new light on the role of economic diplomacy. In particular, they suggest a separate and distinct role for economic diplomacy in strengthening inter-state relationships apart from the role of government in correcting for the possible failure of markets to provide sufficient trade facilitating services. Importantly, this role appears to be distinctly larger in countries characterized by greater state involvement in economic decision-making.

Consistent with expectations, the estimation results show that Canada consistently exports more to larger and richer countries, and less to poorer and more distant ones. Higher value-to-weight manufactures have a wider radius of trade than raw materials. Reflecting the importance of ocean freight to trade, Canada's trade is less

8 The details of the empirical approach are set out in a companion technical paper available at www.cdhowe.org.

intensive with countries that lack good ocean freight connections (although the negative effect disappears for manufactures, which may reflect the use of air freight), and more with islands (although the island effect also weakens for manufactures). Common English language and common British colonial ties are associated with higher levels of exports and have a stronger impact than common French language or common French colonial links (the latter has, in fact, no significant effect).

Canada's comparative advantage in resources and resource-based products results in higher overall exports to countries with complementary rather than competing trade orientations; however, for manufacturing goods, Canada ships more to more similar countries, likely a reflection of intra-industry value-chain trade. For total trade, Canada's exports tend to be about 25 percent less with a country that is most similar (e.g., Australia), as compared to a country that is most dissimilar (e.g., China). However, for manufactured goods, exports tend to be 105 percent larger to the more similar countries.

Having an Free Trade Agreement (FTA) in place is important: Canada's FTAs expand total goods exports by 77 percent, total exports excluding mined products by 82 percent, and manufactures by 92 percent.[9]

The results are broadly stable when Australia is included as an exporter alongside Canada (although the negative effect of distance on export intensity increases) and/or when the United States is excluded as a destination market. These tests reinforce confidence in the robustness of the results – including the estimated impact of Canada's FTAs on exports, an effect that withstands removing the role of the Canada-US FTA from the estimation.

Against this background, the impact of having diplomatic representation in a destination market can be assessed by introducing variables into the equation that indicate whether Canada had an embassy in a given destination market in a given year, as well as the number of consulates or trade offices.

Having an embassy in a destination market boosts exports. In the benchmark equation, the boost to total goods exports is 29 percent. The impact is stronger on exports excluding mined products (39 percent), but markedly smaller for manufactures (9 percent). If the Canadian posts in Taiwan and Hong Kong – which are respectively labelled a trade office and a consulate but which are the highest form of representation available under the political circumstances, and which interact with the territorial government in similar ways an embassy normally would – are moved into the embassy column, the impact of an embassy increases to 35 percent for total exports, 45 percent for exports excluding mined products, and 16 percent for manufactures.

By contrast with the impact of an embassy, the impact of a consulate or trade office is very small and statistically insignificant. Interestingly, however, Canada's exports to destinations where Canada enlists Australia's posts to handle consular matters are reduced by about 20-30 percent compared to otherwise.

The small measured impact on export levels of consulates and trade offices may reflect the fact that not all consulates have major economic mandates and that the number of professional trade promotion staff and the size of the trade promotion budget varies. As Biesebroeck, Chen and Yu (2010) show, Canada's export promotion activities demonstrate that only a very small fraction of Canadian exporters avail themselves of these services – even though the impact on exports for those firms that do make use of such services is quite large.

A further consideration is that additional posts in a country typically have regional/sectoral mandates. A consulate general in Chongqing or a trade office in Chengdu may, for example, boost exports to those regional markets by a very large percentage; however, these additional exports may be small relative to total exports to China.

9 For a discussion of whether Canada's FTAs "cause" trade see the companion piece.

The above results suggest that the level of diplomatic representation matters – by the same token it appears that political relationships matter. This conclusion is further tested by introducing into the analysis a variable that measures the economic role of the state in destination markets. For this purpose, the Fraser Institute's index of economic freedom is used, specifically the total freedom of the world index (EFI) and the sub-index for freedom to transact business across borders (EFI-trade).

The EFI and EFI-trade variables generally have limited explanatory power when tested in equations that do not include posts variables. When the embassy variable is added, however, the EFI variable becomes statistically significant, which suggests an important interaction between the presence of an embassy and the impact on trade of restrictions on economic freedom in the destination market. The inference is that embassies reduce the inhibiting effect on exports of lower levels of economic freedom. Once the positive effect of economic diplomacy is taken into account, the negative effect on trade of restrictions on economic freedom is more fully exposed – by the same token, the positive effect of diplomatic representation is thrown more starkly into relief.

The effect of economic freedom in the importing country varies in a meaningful way across types of exported products. For total exports and goods excluding mined products, the effect is smaller than for manufactured goods. This undoubtedly reflects again the fact that trade in many resource-based products may be driven as much by state procurement as by business relationships. Manufactured products, however, thrive better in contexts where business is free to make its own decisions.

Summary and Conclusions

The analysis in this paper suggests four major conclusions. First, there is a clear association between having diplomatic representation in a country and the level of exports to that country. Second, the impact varies by the level of representation and there appear to be diminishing returns: additional posts generate much less export value than the first, principal post. Third, the impact also varies by type of product, with exports excluding mined products benefiting more from diplomatic representation than total exports, or than manufactured goods. Fourth, there is a powerful interaction between the degree of economic freedom and diplomatic representation in an export destination: as economic freedom declines, the positive impact of diplomatic representation rises.

The main policy implication is that it is more important to broaden the network of first posts (preferably at the highest level) in destination markets, than it is to deepen the network of additional posts in any destination market. Secondly, the results suggest that there is a definite importance in the "G2G" (government-to-government) relationship as distinct from the role of government in providing "B2B" (business-to-business) trade facilitation. That is, economic diplomacy is not a simple question of government stepping in to correct a market failure of inadequate provision of trade facilitation services for companies seeking to break into foreign markets. At the same time, it is important to emphasize that simple "count" variables (the number of consulates or trade offices) may be inadequate to capture the marginal effect of an additional such post abroad.

I conclude that there is a complex interaction between politics and business that is revealed by the interaction between the level of trade, the role of the state in economic decision-making, and the level of diplomatic representation in a country. Trade is, at the end of the day, a "relationship" business after all – the more so when one country's offerings are little differentiated from those of the next. Without gainsaying the case for pure trade facilitation, getting the political relationships right also matters.

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